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CONSIDERATIONS FOR ECONOMIC ZONES AND THE CASE FOR TIMOR-LESTE

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ACRONYMS AND ABBREVIATIONS

EPZ	Export Processing Zone
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GNI	Gross National Income
LLP2	Land Law Program II
NGO	Nongovernmental Organization
SEZ	Special Economic Zone
USAID	United States Agency for International Development

1.0 BACKGROUND

The Government of Timor-Leste has announced its intention to focus on export promotion.[1] In recent months, it has taken a number of steps including holding several workshops on the recently promulgated Investment Laws (domestic and foreign), findings on Investment Opportunities and the development of a standard trade policy to promote exports. Government and private sector stakeholders have emphasized in Timor-Leste's export promotion discussions the importance of expanding *domestic* exports through diversification of non-oil exports and local linkages with the economic zones.

[1] The government is in the process of establishing an Investment and Export Promotion Institute.

2.0 GENERAL CONCEPTS

Economic zones are defined generally as geographically delimited, operating under a single, unified administration, enjoying geographic eligibility for benefits and incorporating purpose-built facilities. Other commonly used terminologies include industrial free zones, free trade zones, special economic zones (SEZs) and *maquiladoras*. An export processing zone (EPZ) is a fenced-in industrial estate specializing in manufacturing of exports that offers firms free trade conditions and a liberal regulatory environment.[2] Economic zones are only one of many trade policy instruments used to promote non-traditional exports. These products generally rely on imported materials and draw less on locally sourced materials. Historically, the majority of economic zones concentrate on the production of garments, electronics and data processing. Common features of zones include:

- Unlimited duty-free imports of raw materials, intermediate input and capital goods necessary for the production of exports;
- Less governmental red-tape, including more flexibility with labor laws for the firms in the zone than for those operating in the domestic market;
- Generous and long-term tax holidays and concessions for both domestic and foreign firms operating in the zone;
- Above average communications services and infrastructure compared to those available in the rest of the country;
- Subsidized utilities and rental areas;
- Presence of domestic, international or joint venture firms—the role of FDI is prominent; and
- Limited sales of goods to the domestic market.[3]

2.1 REASONS FOR ESTABLISHING A SPECIAL ECONOMIC ZONE (SEZ)

Special economic zones are generally viewed as: 1) a pilot project for country-wide reform; 2) on part of a general liberalization strategy; or 3) an attempt to focus scarce resources on key areas. EPZs are sensitive to the national economic environment and will perform better when the country follows sound macroeconomic policies. A country that has already undertaken trade and macroeconomic reform without success should recognize that insufficient FDI may be occasioned by an inadequate legal/regulatory framework or distorted economic incentives in other areas of the economy such as private property laws.

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[2] As defined by the World Bank publication, Export Processing Zones, 1992.

[3] See Madani, Dorsati.

2.2 OBJECTIVES

Well-designed or "successful" zones: 1) attract FDI to the country; 2) provide jobs and employment opportunities; and 3) act as a catalyst for economic development in the rest of the country. Success depends on a number of key factors including political will and focused objectives; location and access to good infrastructure; a stable political environment; coordination with comprehensive country-wide reform; taxes and financial incentives offered; transparent and simple customs regulations; minimal bureaucracy; flexible labor laws; and a highly disciplined and easily trainable workforce.

2.3 COSTS AND BENEFITS

The government should consider how resources would have been allocated in the absence of an economic zone and expectations about the potential impacts of SEZs should be managed. Would capital have remained in the country and would employment have been created in more productive areas? Successful SEZs have achieved the basic goals of creating employment and attracting foreign exchange earnings. However, employment can be unpredictable and short-term by nature. Most opportunities are created in the form of non-traditional employment and income opportunities for women, thus economic zones may not be a solution to high male unemployment.

TABLE 1. POSITIVE AND NEGATIVE IMPACT OF Export Processing Zones (EPZs)

	Negatives	**Positives**
Job creation	• Lack of job security, work often short-term • Prone to demand shocks • Employment expectations not met, potential for continued male unemployment • Labor force drawn from traditional activities, i.e., agriculture	• Trained workers may be employed by firms outside of the zone • Employment generation for women
Foreign exchange earnings	Gains may be overstated	Increases compared to levels before EPZ
FDI	Increased FDI	Investment may occur in response to distortionary incentives rather than to true competitive conditions
Gross exports	Net exports not as impressive because of high import content of exports	Increases compared to levels before EPZ
Revenue	• Foregone taxes and tariff revenues • Opportunity cost of public investments related to the zone may be high	More clearly defined tax base leading to more efficient tax collection
Catalyst/ demonstration effect in rest of economy	Regions and areas outside of the zone do not always develop	Focused government policy needed to diffuse these gains
Training	Skills are generally low-tech	• Provide additional training to Timorese citizens • Management and supervisory training often provided
Poverty levels	Percentage of population still living in poverty: mineral (80%); services (43%), and export manufacturing (25%)	Develop alternative industries such as tourism and recreation which have higher levels of community involvement

Source: Adapted from Madani, Dorsati.

3.0 THE SEZ EXPERIENCE IN TWO AFRICAN COUNTRIES

Table 2 provides a comparison of a "successful" zone (Mauritius) and an "unsuccessful" one (Senegal). It also summarizes Timor-Leste's current stage of development. Senegal and Mauritius were similar in terms of having stable political environments, favorable tax/financial incentives and lax customs regulations. Senegal actually offered more allowances with complete exemptions from taxes on corporate income and dividends whereas Mauritius continued to levy a 15% flat corporate tax. Senegal also gave exemptions on semi-finished and finished goods which were not offered by Mauritius. However, the two countries also differed in key aspects. Senegal had a high cost of infrastructure which made up 25% of the price of the exported good, low availability of skilled labor and excessive bureaucracy. This resulted in a peak of merely 1,200 jobs in Senegal versus almost 91,000 in Mauritius.

TABLE 2. AN UNSUCCESSFUL AND SUCCESSFUL EPZ

	Senegal – Unsuccessful	Mauritius – Successful	Timor-Leste – To be determined
Political environment	Stable	Stable	Stable
Taxes and financial incentives	Exemptions from taxes on corporate income and dividends. Unrestricted repatriation of profits and capital	15% corporate tax over lifetime of company, compensating increase of income tax exemptions on dividends from 5 to 10 years. Free repatriation of profits, capital and dividends	In progress, some tax exemptions are outlined in foreign and domestic investment law
Customs Regulations	Exemptions from customs duties on machinery, inputs, semi – finished and finished goods	Exemptions from excise and duties on productive machinery and parts, raw materials and components	Import tax of 6%, varied excise tax, no export tax
Bureaucracy	Excessive red tape and bureaucracy in processing investor applications	Streamlined government services and minimal interference	Investment and Export Promotion Institute to be established to minimize bureaucracy
Labor market	Low labor productivity	Abundant, educated labor	Low labor productivity
Employment regulations	▪ Minimum employment levels ▪ Government mandated restrictions on hiring and firing of workers	Favorable laws for termination of employment and overtime	N/A
Peak Employment	1,200	90,861	N/A
Investment requirements	Minimum investment levels	N/A	In progress – some details outlined in foreign and domestic Investment Law
Infrastructure	High utility and transportation costs making up 25% of final exported good	N/A	High cost of infrastructure

TABLE 2. AN UNSUCCESSFUL AND SUCCESSFUL EPZ			
	Senegal – Unsuccessful	**Mauritius – Successful**	**Timor-Leste – To be determined**
Other	Government did not provide standard rental factory space. Investors required to lease and build their own factories	N/A	Private property laws not yet established

Source: Adapted from Madani; Timor Leste Foreign Investment Law (2004); Government Trade Policy Workshop, July 13, 2005.

TIMOR-LESTE TRADE POLICY WORKSHOP

One strength Timor-Leste offers is governmental commitment. The Prime Minister clearly outlined this position in his opening speech at a workshop on trade policy attended by government, private sector and NGO representatives. [4] Five separate working groups came to similar conclusions that to be competitive in attracting FDI and promoting exports, Timor-Leste should offer generous tax / financial incentives; improve its infrastructure significantly, particularly roads and electricity; minimize the red tape which currently exists in most areas of the government; and clarify supporting legislation such as private property and bankruptcy laws. The groups raised concerns that while key aspects of supporting legislation had been promulgated, they were currently not being implemented, such as the commercial societies act. Timor-Leste's current tax regime of 6% on imports and sales is still too high. A representative from the Customs Department also underlined the importance of providing exemptions on the import of machinery and materials used in the production of exports.

4 Trade Policy Workshop, Dili, Timor-Leste, July 13, 2005.

4.0 THE CASE OF TIMOR-LESTE

The government has designated five locations and a total of seven zones, each covering approximately 50 hectares. None of these sites have been previously used as economic or industrial zones, and only two (Lautem and Baucau) of the seven sites have been recognized as industrial zone sites by the local communities. However, the government is considering establishing a "small area zone" which has no geographical boundaries but which would offer the same incentives as firms operating in a specified area.[5]

TABLE 3. DESIGNATED LOCATIONS AND SIZE OF INDUSTRIAL ZONES

District	Site	Size (ha)	Population[6]	Zone Land Status[7]
Dili	Hera, Beraka	49	167,777	No
Baucau	Carabela, Vemasse	50	104,571	Yes
Manufahi (2)	Not identified	50	44,235	No
Cova Lima (2)	Suai	50	55,941	No
Lautem	Los Palos, Teno	50	57,453	Yes

According to the government, the sites were chosen based on several criteria including adequacy of infrastructure (ports, airports, roads, power and water); appropriateness of the landscape (flat, easy to develop, access to facilities); distance to agricultural resources; size of land, and availability of labor.

TABLE 4. Existing Infrastructure

District	Site	Commercial Port	Road Condition	Airport
Dili	Hera, Beraka	Yes	Good	Yes
Baucau	Carabela, Vemasse	Yes	Good	Yes
Manufahi	Not identified	No	Fair to very poor	Airstrip
Cova Lima	Suai	No	Fair to very poor	Airstrip
Lautem	Los Palos, Teno	Yes	Good	Airstrip

5 Presentation by Director of Industries, Mr. Manuel Alves.

6 Timor-Leste census (provisional), 2004

7 Based on preliminary research data from ARD LLP2 which recorded whether the community had been informed that the site had been designated an industrial zone.

An infrastructure and population perspective suggests that the most viable locations lie in the districts located in the northeastern part of the country, i.e., Dili, Baucau and Lautem. These three districts all benefit from both access to a commercial port and relatively good road conditions. Dili and Baucau also have large populations, 167,777 and 104,571, respectively. The districts of Manufahi and Cova Lima both have no commercial port, poor road conditions and only an airstrip; however, Suai town (Cova Lima) is very close to a beach landing site.

The main food crops in Timor are cassava, rice and maize. From an agricultural perspective, Baucau and Cova Lima have high gross production of these crops compared to other districts. When evaluated on a per capita basis, Lautem also shows high production yields for cassava. For these three crops, the district of Manufahi does not show particularly impressive production when compared to districts such as Oecussi and in some cases, Viqueque and Bobonaro.

TABLE 5. RANKING OF GROSS PRODUCTION OF MAIN FOOD CROPS IN TIMOR-LESTE BY DISTRICT

District	Cassava (tons)	District Rank	District	Rice (ha of paddies)	District Rank	District	Maize (tons)	District Rank
Cova Lima	7,750	1	Baucau	8,000	1	Cova Lima	11,625	1
Baucau	6,600	2	Cova Lima	2,000	4	Baucau	9,900	3
Lautem	4,000	4	Lautem	2,000	5	Lautem	6,000	5
Manufahi	1,150	9	Manufahi	600	9	Manufahi	1,725	10
Dili	750	11	Dili	120	13	Dili	1,125	12

TABLE 6. PER CAPITA PRODUCTION OF CASSAVA, RICE AND MAIZE BY DISTRICT [in metric tons]

District	Cassava	District	Rice	District	Maize
Cova Lima	0.14	Manatuto	0.09	Cova Lima	0.21
Viqueque	0.10	Baucau	0.08	Viqueque	0.15
Lautem	0.07	Bobonaro	0.07	Bobonaro	0.13
Baucau	0.06	Cova Lima	0.04	Lautem	0.10
Oecussi	0.05	Lautem	0.03	Baucau	0.09
Aileu	0.03	Oecussi	0.02	Oecussi	0.06
Manufahi	0.03	Manufahi	0.02	Aileu	0.05
Liquica	0.02	Ermera	0.01	Manufahi	0.04
Ermera	0.02	Viqueque	0.01	Liquica	0.04
Manatuto	0.02	Liquica	0.01	Ermera	0.04
Ainaro	0.01	Aileu	0.01	Manatuto	0.03
Bobonaro	0.01	Ainaro	0.00	Ainaro	0.02
Dili	0.00	Dili	0.00	Dili	0.01

5.0 SUMMARY OF ISSUES AND RECOMMENDATIONS FOR TIMOR-LESTE

- Focused targets and goals. The government should identify specific sectors in which it would like to attract investment and specify and publicize the goals it wishes to achieve.
- Establishing a SEZ is not a first best policy choice. The best policy is one which promotes overall liberalization of the economy. Zones should be developed in coordination with overall government planning.
- Strengthen legal and regulatory environment to attract foreign investment. The topics this legislation should address the following topics:
  - Taxation: the tax regime should be simple and clear. It should be easy to administer in light of public servants' limited capacity. This will also serve to curb corruption. Foreign firms generally want some sort of long-term tax holidays/concessions but this would depend on Timor-Leste's ability to finance such incentives based on existing or projected revenue streams.
  - Firms want assurance that the government will not nationalize their investments.
  - Land and property rules: regardless of whether they can own the land, foreign firms in particular will insist on having guaranteed long-term user rights to any land they occupy and improve.
  - Labor Laws: a fluid labor market is important for an efficient private sector. High minimum wages and rigid labor laws regarding hiring and firing workers make it difficult for firms to compete in the global economy.
  - Bankruptcy: firms want to know that they can shut down their in-country operations without repercussions.
  - Customs: import and export duties should be clearly defined; customs procedures should be streamlined and efficient.
- Good infrastructure. Investors need access to reliable and reasonably priced infrastructure to run their businesses. In addition, good infrastructure contributes strongly to poverty reduction by improving access to education and health services. An efficient road and sea transportation network should be developed *as soon as possible*, especially in rural areas, in order to entice investors to regions needing the most development.
- Good governance. Corruption is a major problem in developing countries. The government should take a two-pronged approach to controlling corruption by 1) increasing transparency in government procedures and simplifying bureaucratic procedures; and 2) increasing capacity of lower-level civil servants so there is less centralization of control and so line agencies exert more oversight over each other.

- Reduce bureaucratic regulations and red tape to lower the cost of doing business. Developing countries tend to impose more procedures to register and run a business than do developed countries. This adds significantly to the cost of doing business. East Timor should consider streamlining these procedures to minimize costs to business investors.
- Capacity building will, over time, generate a skilled and disciplined labor force. This includes vocational (electrician, mechanic, accounting) training and sector-specific (tourism, agricultural production) training to increase quality of products and services.

6.0 AN ALTERNATIVE MODEL: TOURISM AS THE WAY FORWARD?

Contemporary East Timor would be weak compared to where competing countries were 30 years ago in terms of human capital, sheer number of zones, limited availability of infrastructure services outside of Dili, and investment climate. Increasingly, the focus of economic zones has shifted towards marine- and tourism-focused zones, and with decreasing emphasis on zone location. Countries such as China's Hainan Island and Vietnam's Phu Quoc exemplify creating tourism-specific zones in attractive areas.

Some countries provide the same incentives as those found in free zones but without the geographical constraints. Cape Verde is one such example: the country emphasizes tourism through a free zone package without restricting the location of investments. This flexibility has allowed tourism to become the world's largest industry and, as a result, tourism has fast become an important engine for growth, particularly in small island economies. In addition to the dwindling fisheries resources available to countries, tourism has provided a market for producers of local products, as well as jobs in the visitor catering industry.

CASE STUDY: SOUTH PACIFIC ISLANDS

The countries in the South Pacific provide an interesting regional case study for East Timor to consider. Most of these countries gained independence in the 1970s but some 30 years later, they have moved to different stages of development, in large part powered by post-independence, political stability, and policies adopted. Timor-Leste shares many characteristics with these countries:

- Small populations—most have fewer people than East Timor;
- Limited resource base with regard to natural resources, human resources, and capital;
- Remoteness from major world markets; and
- Lack of industrial base.

They also share similar goals and challenges with Timor-Leste in terms of

- Employment creation,
- Reducing costs of imports,
- Increasing export earnings,
- Increasing skill level among local workers, and
- Environmental and cultural heritage conservation.

Table 7 outlines the key features of each of these countries and the impact that tourism has had on their economies. The countries are grouped according to their degrees of emphasis on tourism (more or less). Tourism makes up anywhere between 9.5% (Samoa) to 47% (Cook Islands) of total GDP for countries choosing to focus on tourism. They experienced annual GDP growth of 3% to 9% over a 10-year period. Countries emphasizing tourism also adopted open policies and had higher GNI[8] / capita. These policies allowed foreigners to lease land for long periods of time, provided low and simple tax regime, and protected investors against expropriation. In contrast, countries without such an emphasis—for example, Papua New Guinea and Tuvalu—demonstrated lower levels of GNI/capita, leased land on a case-by-case basis or with government approval, and gave few specifics on protection from nationalization.

TABLE 7. GENERAL OVERVIEW: PACIFIC ISLAND COUNTRIES

Tourism focus[9]	Country	Foreign ownership of land?	Land can be leased?	GNI per capita (US$)	Aid per capita (US$)	Taxation	Expropriation
Yes	Cook Islands	No	Yes. Maximum 60 years.	N/A	N/A	Company tax 20%. VAT 12.5%.	Investment Act defines
Yes	Fiji	Yes, but limited	Yes. From traditional owners or Government	2130	41	Company tax 20%. VAT 12.5%.	Constitution provides protection
Yes	Tonga	No	Yes	1440	220	Resident company tax, 15% for first US$72,290 of earnings and 30% over that amount Non-resident, 37.5% for first US$36,145 of earnings and 42.5% on earnings over that amount	Not specified On earnings
Yes	Vanuatu	No	Yes. Maximum 75 years.	1070	134	No company tax. 10% hotel and licensed premises tax on turnover. VAT 12.5% on gross turnover for amounts of over US$30,400.	N/A
Yes	Samoa	No	Yes	1430	215	Company tax 35%	N/A
No	Papua New Guinea	N/A	Case – by –case basis	530	38	Resident companies (non-mining or petroleum) 25% Non-resident companies (including mining) 48%	Investment Promotion Act guarantees protection.
No	Solomon Island	No	Yes	580	59	Resident company tax: 30% Non-resident company tax: 35%	No formal laws in place
No	Tuvalu	No	Yes, but only with approval	N/A	N/A	Foreign resident companies pay 40% of profits	Unspecified which laws govern
No	Kiribati	No	Yes. Long –term unspecified	960	220	Company tax 25% of net profits for first US$38,500 and 35% for profits above that amount.	Not defined

Source : World Development Indicators, 2004. South Pacific Tourism Organization

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[8] Gross national income.

[9] As determined by the South Pacific Tourism Organization.

TABLE 8. PACIFIC ISLAND TOURISM STATISTICS

Focus on Tourism	Country	Total population[10]	Tourism as % of GDP	Tourism as % of Employment	Average annual GDP growth (%) 1990-95	Average annual GDP growth (%) 1995-00
More	Cook Islands	N/A	47%	N/A	7.1	8.7
	Fiji	823,000	12.8%	9.5%	2.7	-1.6
	Tonga	101,000	14.7%	3.2%	6.7	3.8
	Vanuatu	206,000	16.6%	12.0%	4.7	5.7
	Samoa	176,000	9.5%	10.0%	7.2	5.3
Less	Papua New Guinea	5,000,000	6.3%	3.2%	0.5	6.7
	Solomon Island	443,000	2.9%	1.6%	5.9	N/A
	Tuvalu	N/A			-2.1	4.1
	Kiribati	95,000	14.5%	1.7%	5.4	4.2
	Timor Leste	780,000	N/A	N/A	N/A	N/A

Source: World Development Indicators, 2004. South Pacific Tourism Organization

10 World Development Indicators, 2004.

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